

REVISED
REDACTED
DIRECT TESTIMONY
OF
ROCHELLE PHIPPS

FINANCE DEPARTMENT
FINANCIAL ANALYSIS DIVISION
ILLINOIS COMMERCE COMMISSION

PETITION FOR APPROVAL OF TRANSFER OF GAS SYSTEM ASSETS AND GAS
PUBLIC UTILITY BUSINESS AND FOR APPROVAL OF ENTRY INTO VARIOUS
AGREEMENTS RELATED THERETO

UNION ELECTRIC COMPANY
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY

DOCKET No. 03-0657
FEBRUARY 5, 2004

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Introduction

1. Q. State your name, employer and business address.

A. My name is Rochelle Phipps. I am employed by the Illinois Commerce Commission ("Commission"), 527 East Capitol Avenue, Springfield, Illinois 62701.

2. Q. What is your current position with the Commission?

A. I am currently employed as a Senior Financial Analyst in the Finance Department of the Financial Analysis Division.

3. Q. Describe your qualifications and background.

A. In May 1998, I received a Bachelor of Arts degree in Finance from Illinois College in Jacksonville, Illinois. In May 2000, I received a Master of Business Administration degree from the University of Illinois at Springfield. I have been employed by the Commission since June 2000.

4. Q. What is the purpose of your testimony in this proceeding?

A. I will present my evaluation of the asset transfer ("reorganization") proposed by Central Illinois Public Service Company ("AmerenCIPS") and Union Electric Company ("AmerenUE") under Sections 7-204(b)(4), 7-204(b)(7) and 6-103 of the Public Utilities Act ("Act"). Section 7-204(b)(4) pertains to the proposed reorganization's financial implications on AmerenCIPS' ability to access the capital markets on reasonable terms and maintain a reasonable capital structure. Section 7-204(b)(7) pertains to whether the proposed reorganization is likely to result in any adverse

rate impacts on retail customers. Section 6-103 pertains to the amount of AmerenCIPS' capitalization following the reorganization.

Under the terms of the Asset Transfer Agreement among AmerenUE, AmerenCIPS and Ameren Corporation ("Ameren Corp."), AmerenUE will transfer 50% of its Illinois jurisdictional combined electric and gas assets ("Metro East assets") to AmerenCIPS in exchange for a promissory note. (Second Amended Petition, paragraph 10.) I will present my evaluation of the proposed indebtedness related to the reorganization under Sections 6-102 and 6-108 of the Act. Section 6-102 pertains to whether the proposed indebtedness is in the public interest. Section 6-108 sets forth the fees assessed for Commission-authorized indebtedness.

AmerenCIPS and AmerenUE are both first tier subsidiaries of Ameren Corp. (Second Amended Petition, paragraph 3.) Accordingly, AmerenCIPS and AmerenUE are affiliated interests under Section 7-101 of the Act. (220 ILCS 5/7-101.) Thus, I will evaluate the promissory note that AmerenCIPS intends to issue to AmerenUE in exchange for 50% of AmerenUE's Metro East assets under Section 7-101 of the Act, which pertains to whether the proposed indebtedness related to the reorganization is in the public interest.

5. Q. Describe the proposed reorganization

A. Under the terms of the Asset Transfer Agreement, AmerenUE will transfer 50% of the Metro East assets net of liabilities to AmerenCIPS in exchange for a promissory note in an amount equal to 50% of the total net book value, estimated to be approximately \$69 million. AmerenUE will also

53 declare an “in kind” dividend to Ameren equal to the remaining balance
54 (50%) of the net book value of the Metro East assets net of liabilities,
55 estimated to be approximately \$69 million. Ameren will then transfer the
56 assets and liabilities to AmerenCIPS as a capital contribution. (Second
57 Amended Petition, paragraph 10.)
58

59 **6. Q. Summarize your findings and recommendations.**

60 **A.** In my judgment, the proposed reorganization satisfies the requirements of
61 Section 7-204(b)(4) of the Act. The proposed reorganization also satisfies
62 the requirements of Section 7-204(b)(7) of the Act as it pertains to the
63 electric base rate freeze during the mandatory transition period, provided
64 (1) the Commission requires AmerenCIPS to maintain separate
65 accounting records for the Metro East assets until the end of the
66 mandatory transition period, as defined in Section 16-102 of the Act; and
67 (2) the Commission accepts AmerenCIPS’ commitment that should
68 AmerenCIPS’ rate of return on common equity following the proposed
69 reorganization, as calculated in the manner described in Section
70 16-111(d) of the Act, fall below the applicable yield on U.S. Treasury
71 bonds, AmerenCIPS will not request an increase in electric base rates
72 during the mandatory transition period unless its rate of return on common
73 equity, recalculated as if the proposed reorganization never occurred, also
74 falls below the applicable yield on U.S. Treasury bonds. Additionally, I find
75 the proposed reorganization satisfies Section 6-103 of the Act.
76

77 In my judgment, the indebtedness related to the proposed reorganization
78 satisfies the requirements of Section 6-102 of the Act. Further, I calculated
79 that under Section 6-108 of the Act, AmerenCIPS would owe a fee of 24

cents for every \$100 of the \$69 million principal amount of the promissory note authorized, or \$165,600. Lastly, I recommend that the Commission order AmerenCIPS to file a special report showing how the interest rate was set for the promissory note and quarterly reports for the promissory note in accordance with 83 Illinois Administrative Code 240.

In my judgment, the promissory note satisfies the requirements of Section 7-101 of the Act since (1) the promissory note is necessary to effectuate the proposed reorganization; (2) the proposed reorganization satisfies the requirements of Sections 7-204 and 6-103 of the Act; and (3) the interest rate on the note, set in the manner AmerenCIPS describes, would be consistent with the rate AmerenCIPS would pay on a note issued to unaffiliated interests. Thus, in my judgment, the promissory note is in the public interest.

**Sections 7-204(b)(4), 7-204(b)(7) and 6-103 of the Act:
Requirements Related to Reorganizations**

7. Q. Why is it necessary to evaluate the financial implications of the proposed reorganization?

A. Under Section 7-204(b)(4) of the Act, the Commission must find that the proposed reorganization “will not significantly impair the utility’s ability to raise necessary capital on reasonable terms or to maintain a reasonable capital structure.” (220 ILCS 5/7-204.)

8. Q. How does AmerenCIPS currently obtain equity capital?

A. AmerenCIPS currently obtains equity capital through accumulation of net income. AmerenCIPS also has the ability to obtain additional equity capital through infusions of equity from its parent company, Ameren Corp. (Company response to Staff data request RP-2.01.)

9. Q. How does AmerenCIPS currently obtain debt capital?

A. Currently, AmerenCIPS obtains debt capital in two ways: (1) issuance of securities in the capital markets; and (2) intercompany borrowings as a participant in Ameren Corp.'s utility money pool arrangement, which the Commission approved in Docket No. 98-0664. (Order, Docket No. 98-0664, November 18, 1998.) AmerenCIPS also has the ability to obtain debt capital through borrowings from commercial banks. (Company response to Staff data request RP-2.02.)

10. Q. Does AmerenCIPS currently have access to the capital markets on reasonable terms?

A. Yes. Standard & Poor's ("S&P") categorizes debt securities on the basis of the risk that a company will default on its interest or principal payment obligations. The resulting credit rating reflects both the operating and financial risks of a utility. (Standard & Poor's Utilities Rating Service, "Utilities Rating Criteria," May 20, 1996, p. 1.) S&P rates AmerenCIPS A-. (Standard & Poor's Ratings Direct, "Summary: Central Illinois Public Service Co.," August 21, 2003.) According to S&P, an A-rated utility has a strong capacity to meet its financial obligations. (Standard & Poor's Ratings Definitions, December 21, 2001, pp. 1-2.)

11. Q. How would AmerenCIPS obtain equity and debt capital following the proposed reorganization?

A. Following the proposed reorganization, there will be no change in the manner in which AmerenCIPS obtains equity and debt capital. (Company responses to Staff data requests RP-2.01 and RP-2.02.)

12. Q. Would the proposed reorganization significantly impair AmerenCIPS' access to capital markets?

A. No. I performed a ratio analysis that indicates AmerenCIPS' financial condition will remain strong following the proposed reorganization. Therefore, I conclude that AmerenCIPS' access to the capital markets will not be significantly impaired following the proposed reorganization.

13. Q. Describe the ratio analysis you performed to evaluate AmerenCIPS' financial condition.

A. S&P publishes targets for the following four financial ratios that it uses in its analysis of investor-owned utilities: (1) funds from operations ("FFO") to total debt; (2) FFO interest coverage; (3) pre-tax interest coverage; and (4) total debt to total capital (hereafter collectively referred to as "S&P Benchmark ratios"). (Standard & Poor's, "Utility Financial Targets are Revised," June 18, 1999.) Those financial ratios measure financial strength. The S&P Benchmark ratio targets vary with S&P's business profile scores, which reflect the operating risk of a utility, such as industry characteristics, the company's competitive position and management. Utilities' business profile scores are evaluated on a scale of one ("1") to ten ("10"). A rating of one denotes below average business risk. A rating of ten denotes above average business risk. (*Id.*) S&P rates AmerenCIPS'

business profile score “3”. (Standard & Poor’s, “Utilities & Perspectives,” January 26, 2004.) Thus, I compared the S&P Benchmark ratios for an A-rated utility with a business profile score of “3” to AmerenCIPS’ financial ratios calculated as of September 30, 2003, December 31, 2004, and December 31, 2005.

AmerenCIPS’ 2003 financial ratios reflect AmerenCIPS’ financial condition without the Metro East assets. I compared AmerenCIPS’ 2003 financial ratios to (1) published S&P Benchmark ratios and (2) average 2002 S&P Benchmark ratios for A-rated electric utilities. Schedule 1.1 presents AmerenCIPS’ 2003 financial ratios, the S&P Benchmark ratios for A-rated utilities with the same business profile score as AmerenCIPS, and the 2002 average S&P Benchmark ratios for A-rated electric utilities. As shown on Schedule 1.1, AmerenCIPS’ 2003 financial ratios are slightly below the S&P Benchmark Ratios for A-rated utilities and the average S&P Benchmark ratios for A-rated electric utilities.

To assess the impact of the proposed reorganization on AmerenCIPS’ financial ratios, I calculated the S&P Benchmark ratios for AmerenCIPS using AmerenCIPS’ forecasted 2004 and 2005 financial statements. Note that AmerenCIPS’ forecasted 2004 and 2005 financial statements reflect not only the gas and electric asset transfer, but also a rate increase authorized by the Commission in Docket Nos. 02-0798/03-0008/03-0009 Consolidated. (Order, Docket Nos. 02-0798/03-0008/03-0009, October 22, 2003.) I compared AmerenCIPS’ forecasted 2004 and 2005 financial ratios to (1) published S&P Benchmark ratios and (2) average 2002 S&P Benchmark ratios for A-rated electric utilities. As shown on Schedule 1.1,

AmerenCIPS' forecasted 2004 and 2005 financial ratios compare favorably to the published S&P Benchmark ratios and the 2002 average ratios for A-rated electric utilities. Thus, in my judgment, the proposed reorganization will not significantly impair AmerenCIPS' access to the capital markets.

14. Q. AmerenCIPS is a combination gas and electric utility. (Second Amended Petition, paragraph 2.) Explain why you compared AmerenCIPS' financial ratios to the average ratios for A-rated electric utilities.

A. During 2002, 80% of AmerenCIPS' revenues were generated from its electric operations. Likewise, approximately 80% of AmerenCIPS' total gross margin (i.e., revenues less fuel and purchased power costs) came from its electric operations. (Central Illinois Public Service Company, Form 10-K for the fiscal year ended December 31, 2002.) The proposed reorganization would not significantly change the relative proportions of revenues and gross margin for electric and gas operations. (Second Amended Petition, Second Proprietary Appendix B.) Thus, comparing AmerenCIPS' financial ratios to the electric industry is appropriate since AmerenCIPS' earnings are derived primarily from electric operations.

15. Q. Describe the circumstances under which the proposed reorganization could result in an adverse impact on electric base rates.

A. An adverse rate impact would occur if the proposed reorganization reduced AmerenCIPS' rate of return on common equity to a level that would entitle AmerenCIPS to request an increase in electric base rates

pursuant to Section 16-111(d) of the Act that AmerenCIPS could not have requested absent the reorganization. Although not a part of this proposed reorganization, Staff was also concerned that circumstances had changed sufficiently since 2000 such that the transfer of AmerenUE's retail electric operations in Illinois to AmerenCIPS could also entitle AmerenCIPS to request an increase in its electric base rates.¹

16. Q. In the Additional Supplemental Direct Testimony of Craig D. Nelson, AmerenCIPS commits that if during the remainder of the mandatory transition period, AmerenCIPS' actual two-year average earned rate of return on common equity ("ROE"), calculated in accordance with Section 16-111(d) of the Act, falls below the two-year average yield of the applicable U.S. Treasury securities for the same period, AmerenCIPS will adjust its ROE as though the asset transfer had not occurred. Do you agree with AmerenCIPS' proposal?

A. Yes. Under AmerenCIPS' proposal, AmerenCIPS will be entitled to request an increase in its base rates pursuant to Section 16-111(d) only if AmerenCIPS' two-year average ROE, adjusted as though the asset transfer had not occurred, is still below the two-year average yield of the applicable U.S. Treasury securities. Accordingly, I recommend the Commission approve that commitment and require AmerenCIPS to maintain separate accounting records for the Metro East assets until the end of the mandatory transition period. The latter requirement would ensure that the alternative ROE could be calculated, if necessary.

¹ The Commission approved the transfer of AmerenUE's retail electric operations in Illinois to AmerenCIPS in docket nos. 00-0650/0655 Consolidated. (Second Amended Petition, paragraph 7; Order, Docket Nos. 00-0650/0655 Cons., December 20, 2000.) That transfer has not yet occurred because AmerenUE has not received such approval from the Missouri Public Service Commission. (Second Amended Petition, pp. 1-2.)

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17. Q. Based on your analysis and AmerenCIPS’ commitment that AmerenCIPS’ acquisition of the Metro East assets will not result in an electric base rate increase under Section 16-111(d) of the Act, in your judgment, does the proposed reorganization satisfy the requirements of Section 7-204(b)(7) of the Act as it pertains to electric base rates?

A. Yes.

18. Q. Why is it necessary to review the capitalization of a public utility following reorganization?

A. Section 6-103 of the Act requires that in any reorganization, the Commission shall authorize the amount of capitalization of a public utility formed by a reorganization, which shall not exceed the fair value of the property involved. (220 ILCS 5/6-103.)

19. Q. In your judgment, does the proposed reorganization satisfy the requirements of Section 6-103 of the Act?

A. Yes. AmerenUE’s Metro East assets are being transferred to AmerenCIPS for an amount equaling their net book value. (Second Amended Petition, paragraph 10.) Thus, the proposed reorganization satisfies the requirements of Section 6-103 of the Act.

**Sections 6-102, 6-101, 6-108 and 7-101 of the Act:
Requirements Related to Proposed Indebtedness**

20. Q. Describe the requirements set forth in Sections 6-102 and 6-101 of the Act that relate to the promissory note AmerenCIPS will issue in connection with the proposed reorganization.

A. Section 6-102(a) requires Commission authorization before public utilities can issue indebtedness payable at periods of more than twelve (12) months, provided that in the Commission's opinion, such indebtedness is reasonably required for the purpose specified in the Order. Section 6-102(b) allows the Commission to attach conditions to the indebtedness as it deems necessary. (220 ILCS 5/6-102.) Section 6-101 requires that the Commission provide an identification number for indebtedness authorized pursuant to Article VI of the Act. (220 ILCS 5/6-101.) Lastly, the Commission may order the public utility to submit quarterly reports related to the debt issuance. (83 Ill. Adm. Code 240.)

21. Q. Describe the terms of the promissory note between AmerenCIPS and AmerenUE.

A. Under the terms of the Asset Transfer Agreement, AmerenUE will transfer 50% of the Metro East assets net of liabilities to AmerenCIPS in exchange for a promissory note in an amount equal to 50% of the total net book value, estimated to be approximately \$69 million. The promissory note will have an initial five-year term, with a ten-year amortization schedule, with a balloon payment at the end of the fifth year, unless the note's term is extended for an additional five years by agreement of the parties. The

promissory note will be subordinated to all other of AmerenCIPS' debt.
(Second Amended Petition, paragraph 10.)

22. Q. Describe the conditions under which the Joint Applicants may extend the note's term an additional five years.

A. Other than upon agreement of both parties, there are no specific provisions or conditions that must be satisfied in order to extend the term of the promissory note at the end of the fifth year. In the instant docket, the Joint Applicants are not requesting regulatory approval to extend the term of the promissory note. (Company response to Staff data request RP-4.09.)

23. Q. What is the expected interest rate for the promissory note?

A. The promissory note interest rate will be based on the current market rate at the time AmerenCIPS issues the promissory note. (Second Amended Petition, paragraph 10.) Specifically, the actual interest rate will be based on interest rates charged for comparable unsecured five-year notes issued by companies whose credit quality and bond ratings are comparable to those of AmerenCIPS. The formula used to derive the interest rate will be based on yields on the five-year U.S. Treasury notes and bonds having five years remaining until maturity, plus a premium based on AmerenCIPS' credit quality and the terms of the promissory note. (Company response to Staff data request RP-4.08.) Based on current market conditions, the Joint Applicants estimate the promissory note will bear an interest rate of approximately 4.75%. (Company response to Staff data request RP-1.02.) Given the exact interest rate of the proposed indebtedness is currently unknown, Staff recommends that the

Commission Order indicate that approval of the indebtedness should not be construed as a determination that the promissory note's interest rate is reasonable for ratemaking purposes.

24. Q. How will the proposed promissory note, in conjunction with the equity infusion, affect AmerenCIPS' capital structure?

A. On September 30, 2003, AmerenCIPS' capital structure comprised approximately 2% short-term debt, 45% long-term debt, 8% preferred stock and 45% common equity. (Ameren Corporation, Form 10-Q for the quarterly period ended September 30, 2003.) A pro forma analysis that adjusts the September 30, 2003 capital structure ratios to reflect additional long-term debt totaling \$69 million and additional equity capital totaling \$69 million results in the following capital structure for AmerenCIPS: 2% short-term debt, 46% long-term debt, 7% preferred stock and 46% common equity. Thus, AmerenCIPS' capital structure ratios will remain substantially the same following the proposed reorganization.

25. Q. Do you recommend the Commission authorize AmerenCIPS to issue the promissory note in exchange for 50% of AmerenUE's Metro East assets?

A. Yes. I recommend the Commission authorize AmerenCIPS to issue a promissory note to AmerenUE in exchange for AmerenUE's Metro East assets in an amount equaling 50% of the net book value of those assets up to a maximum of \$69 million subject to the following conditions: (1) AmerenCIPS seeks Commission authority before agreeing to extend the promissory note from five to ten years; (2) within ten business days of establishing an interest rate on the note, AmerenCIPS file a special report

with the Commission disclosing that interest rate and demonstrating how that interest rate was set, including supporting source documents; and (3) AmerenCIPS submit quarterly reports in connection with the promissory note, as described in 83 Illinois Administrative Code 240.

26. Q. Does AmerenCIPS owe any fees to the Commission in connection with the proposed indebtedness?

A. Yes. Should the Commission authorize the proposed indebtedness, Section 6-108 of the Act requires AmerenCIPS pay a fee equal to 24 cents for every \$100 of the principal amount of the promissory note due no later than 30 days after the Commission authorizes such indebtedness. (220 ILCS 5/6-108.) AmerenCIPS requests authority to issue indebtedness in an amount not to exceed \$69 million. (Second Amended Petition, paragraph 10; Company response to Staff data request RP-8.01.) Thus, AmerenCIPS estimates it will owe fees totaling \$165,600 due within 30 days of the Commission Order authorizing such indebtedness. (Company response to Staff data request RP-2.04.) I agree with AmerenCIPS' estimate of the Section 6-108 fees due for the authority to issue the proposed indebtedness.

27. Q. Describe the requirements of Section 7-101 of the Act.

A. Section 7-101(3) of the Act states that a financial contract for the exchange of any property made with any affiliated interest requires Commission approval. The Act states further that the Commission may attach any conditions to its approval that are necessary to safeguard the public interest. (220 ILCS 5/7-101(3).)

365 **28. Q. Is AmerenCIPS' proposed debt issuance in the public interest?**

366 **A.** Yes. AmerenCIPS' proposed debt issuance is necessary to consummate
367 the proposed reorganization, which satisfies the requirements set forth in
368 Articles VI and VII of the Act. Thus, the proposed debt issuance is in the
369 public interest.

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371 **29. Q. Does this conclude your direct testimony?**

372 **A.** Yes.

AmerenCIPS' Current & Forecasted S&P Benchmark Ratio Analysis

	AmerenCIPS				
S&P Benchmark Ratios	Actual Twelve Months Ended September 30, 2003	Forecasted December 31, 2004	Forecasted December 31, 2005	S&P Financial Targets for A-Rated Utilities with a "3" Business Profile Score	Average Ratios for A-Rated Electric Utilities in 2002
Funds Flow from Operations to Total Debt	11%	These ratios have been redacted because they were calculated using data provided in the Joint Applicants' Second Amended Petition, Proprietary Revised Appendix B.		20% - 26%	26%
Funds Flow from Operations Interest Coverage	2.7X			3.1X – 3.9X	5.7X
Pre-Tax Interest Coverage	2.2X			2.8X – 3.4X	4.0X
Total Debt to Total Capital	47%			47.5% - 53%	53%

Sources:

AmerenCIPS Form 10-Q for Quarterly Period Ended September 30, 2003
AmerenCIPS Form 10-K, December 31, 2002
Joint Applicants' Revised Appendix B
Standard & Poor's, "Utility Financial Targets are Revised," June 18, 1999
Standard & Poor's Utility Compustat